RETIREMENT

Retirement TIPS: Never Outlive Your Money with Inflation-Protected Bonds

What if you were about to retire and could put all of your savings in a single, ultra-low-risk investment with near certainty that you would never outlive your money? Well, maybe you can with Treasury Inflation-Protected Securities.

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Well, maybe you can with Treasury Inflation-Protected Securities. Two years ago the government expanded its TIPS program to include a 30-year maturity, and it has changed the retirement income picture, according to a new study.

In determining retirement income, most financial planners allow for a 4% initial drawdown of principal and adjust that drawdown rate each year for inflation. Traditional thinking is that with a sensible mix of stocks and bonds the money will last 30 years.

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The problem is that this thinking is based on calculations that started to surface in the 1990s, a decade when stocks returned an average annual 18.1% and, dating to the 1950s, had average annual returns of nearly 14%. Things look a lot different now; stocks have been dead money for a decade and return assumptions going forward are much lower.

In the current environment, says Robert Huebscher, CEO of the online newsletter Advisor Perspectives, a traditional portfolio of 60% stocks and 40% bonds offers much less certainty that you will outlive your money. Assuming average annual stock returns of 9.6% (the new long-run figure you get by including the lost decade), you have just a 67% chance of outliving your money. If stocks return just 7.6% a year, the odds of your money lasting 30 years slip to a coin flip.

In this light, TIPS look like a retirement saver. Huebscher ran his analysis in July, when 30-year TIPS yielded 1.6%. That may not sound like much. But remember that this is a virtually riskless after-inflation return. No stock market risk; no bond market risk to speak of. These are Steady Eddies that deliver year in and year out.

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The upshot of Huebscher's study: Using an inflation-adjusted 4% annual drawdown rate and with all of your money in 30-year TIPS, you have a 97% chance of outliving your money. The one risk is that market interest rates rise faster than inflation, which happens from time to time. But even then TIPS give you a 77% chance of not outliving your money.

As it happens, this market-rate risk is acute at the moment. Since Huebscher ran his numbers in July, a global panic has sent investors streaming into Treasury bonds for safety, driving down TIPS yields irrespective of inflation pressures. Indeed, 30-year TIPS now yield something like 1%. That is so abnormally low that it almost certainly will not last. For now, Huebscher says, his TIPS strategy needs to be put on hold. That's because rates will almost certainly correct by moving higher — irrespective of inflation pressures — in the near future.

But as the TIPS yield moves back to 1.6% and higher, he says, "if you have sufficient funds so that you'll only need a 4% withdrawal rate, yes, the vast majority of your portfolio should be in TIPS."